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March 21, 2006

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd Fl.
Boston, MA 02110

Re: Boston Gas Company, Colonial Gas Company, and Essex Gas Company, each d/b/a KeySpan Energy Delivery New England, D.TE. 06-9

Dear Ms. Cottrell:

On March 16, 2006, the Attorney General of the Commonwealth of Massachusetts filed an initial brief in the above-referenced docket regarding a petition by Boston Gas Company, Colonial Gas Company and the Essex Gas Company each d/b/a KeySpan Energy Delivery New England ("Company" or "KeySpan") for approval, pursuant to G.L. c. 164, § 94A, of a natural gas asset optimization service contract (the "Agreement") with Merrill Lynch Commodities, Inc. ("MLCI"). As proposed, the Agreement would take effect April 1, 2006, for a three-year period terminating on March 31, 2009. In accordance with the procedural schedule set by the hearing officer, the Company hereby submits this reply to the Attorney General's initial brief.

The Attorney General recommends that the Department reject the Agreement and implement a series of recommendations "in the best interest of the Company's customers" (Attorney General at 5).[1] However, as demonstrated below, adoption of these recommendations and rejection of the Agreement will provide no advantage whatsoever over the proposed Agreement in terms of serving the interest of customers. Accordingly, the Department should approve the Agreement as filed.

The Company addresses each of the Attorney General's recommendations in turn below:

[1] Within the Company's reply brief, all references to the Attorney General's initial brief will be to the confidential version.

1. **The Attorney General requests the Department to: (1) reject the Agreement on the basis that the Company's competitive selection process failed to provide a "fair, open and transparent" process; and (2) direct the Company to initiate a RFP process that gives all potential bidders an opportunity to bid to enter into a "co-management agreement."**

According to the Attorney General, the Company made a material change in the nature of the services it sought during the competitive selection process that was not reflected in the request for proposals ("RFP") and that this change deprived bidders of a meaningful chance to put forth a superior proposal (Attorney General Initial Brief at 2-3). Therefore, what the Attorney General takes issue with is the Company's decision not to: (1) commence a new RFP process, or (2) return to the entities submitting the two lower bids to discuss a co-management arrangement. In either case, the Attorney General is suggesting that the Company could have obtained a "superior" value than the proposed arrangement had the Company followed a different process. The record does not support this contention. In fact, the record shows that either course of action would have represented a futile exercise for the Company and that the value obtained for customers is the highest value available in the market for a co-management arrangement. Therefore, for the following reasons, the Department should reject the Attorney General's recommendations relating to the RFP.

First, the record shows that the Company conducted a competitive solicitation process that was fair, open and transparent. The Company issued an RFP to a comprehensive list of wholesale gas marketers and conducted the process through two rounds of bids in a fair and transparent manner because all substantive communications were made in writing and distributed to all parties on an equal basis (Exh. EDA-1, at 13; Exh. KED-DTE-1-2; Exh. KED-AG-1-1, at 12; Exh. KED-AG-1-3). The Company developed a "short-list" of bidders comprised of the two entities that offered the highest value for a traditional outsourcing arrangement (id.; Exh. KED-AG-1-2 (supp.)). The Attorney General does not raise any issue with this portion of the RFP process, nor with the Company's decision to open negotiations only with the two highest bidders.

Second, the record shows that the RFP process enabled the Company to identify the maximum value that would be offered for the right to manage the portfolio under a full outsourcing arrangement (Tr. at 57). In that regard, the Company testified that structuring the arrangement in the original RFP as a "full outsourcing" produced the "total maximum value" because the prospective asset managers valued the arrangement based on the assumption that they would have total discretion over the management of the assets (id.). The Company further testified that, from the asset manager's perspective, co-management of the portfolio is not as desirable as a full outsourcing arrangement because the asset manager has less control over the assets and because there is a requirement to coordinate with the Company and to share expertise (id. at 57-58). Therefore, by negotiating with the two entities submitting the highest bid for a full outsourcing arrangement, the Company was able to negotiate from a high point rather than having to negotiate up from a lower bid (id. at 58-59). This put the Company in a better negotiating position than it would have anticipated had the RFP been structured to solicit bids for a co-management arrangement (id. at 57-58). Therefore, the issuance of an RFP for co-management services would be unlikely to produce "superior" results.

For similar reasons, the Company did not apprise the two original bidders who were excluded from the short list of the change in structure. The record shows that the bids submitted by these entities were priced well below the short-list bidders (in addition to having other detracting features) and would have remained in that relative position even under a co-management arrangement (Exh. KED-AG-1-2; Tr. at 24, 57-59). There is no basis to suggest that these bidders would have provided more value than MLCI under circumstances that would substantially *reduce* the value of arrangement to these bidders.

Lastly, the record shows that each of the two short-listed bidders was provided with the opportunity to submit an offer regarding the co-management arrangement. These two bids were submitted on a competitive basis and were extremely close in value, indicating to the Company that MLCI's proposal represented the market value of the co-management arrangement (Exh. KED-AG-1-2 (supp.)). Therefore, the Company selected MLCI for three reasons: (1) MLCI exhibited a willingness to enter into the Agreement as a co-management arrangement; (2) the Company has knowledge of and experience with MLCI as a reliable and creditworthy partner (Exh. EDA-1, at 14-15; Exh. KED-DTE-1-7); and (3) it offered the best value for customers under a co-management arrangement (Exh. KED-AG-1-2 (supp)).

Therefore, the record shows that the Company conducted a competitive solicitation process that was fair, open and transparent. The record also shows that the process undertaken by the Company produced an agreement that represents the highest possible value for customers based on portfolio and market conditions at the time KeySpan entered into the contract. Accordingly, the Department should reject the Attorney General's recommendations regarding the RFP process and approve the proposed Agreement as filed.

2. The Attorney General requests that the Department reject the Agreement and order the Company to initiate an RFP process to consider bids that provide more favorable payments to customers.

According to the Attorney General, the Company selected MLCI's bid over a number of proposals that would have offered a higher guaranteed payment to customers (Attorney General at 3). Therefore, the Attorney General recommends that the Department reject the proposed Agreement and commence the entire RFP process all over again in the hopes that it will produce "more favorable payments to customers" (id.at 4). The Department should reject the Attorney General's recommendation because a new RFP process will not produce a result better than the proposed Agreement, and therefore, rejection of the Agreement is not in the best interests of customers.

With respect to the Attorney General's claim that the Company selected MLCI's bid over a number of proposals that would have offered a higher guarantee`d payment to customers, the Attorney General overlooks two important facts. First is the fact that other bids did not contemplate a co-management arrangement, and therefore, were based on the assumption that the asset manager would have total discretion and control over the assets (Tr. at 57). The record shows that the value produced by a full outsourcing arrangement is a function of: (1) the level of control of the asset manager over "critical operations" relating to the resource portfolio (Exh. KED-AG-1-7, at 006 (conf.)); the package of resources turned over to the asset manager (Exh. EDA-1, at 23); and (2) the level of autonomy afforded to MLCI on a day-to-day basis in terms of strategy decisions and freedom to execute "last-minute" changes (id.). In addition, the record shows that the amount of value derived from a traditional outsourcing arrangement is derived from aggressive marketing efforts, price-hedging activities and other activities undertaken using the full bundle of portfolio resources (Exh. KED-AG-1-18). Therefore, the bids submitted by MCLI and the next highest bidder in December 2005 for the co-management arrangement cannot be compared to the bids submitted on the premise that the arrangement would continue to be structured as a full outsourcing arrangement with the asset manager having unfettered discretion to enter into optimization activities with the full range of portfolio resources. Therefore, the record shows that, when compared to the bid submitted by the entity competing for the co-management arrangement, the MLCI bid provides the highest value for customers (Exh. KED-AG-1-2 (supp.)).

The second important fact overlooked by the Attorney General is that the amount of the guaranteed payment to customers is *not* the measure of the total value that will be obtained by customers under an asset-management agreement (and this is true regardless of the structure of the arrangement). The purpose of the guaranteed payment is to establish the *minimum* payment that customers will receive (Tr. at 13). The primary consideration for the Company in evaluating the competing bids was not simply the amount of the minimum payment, but also the **total** level of revenues anticipated to be generated through the asset-management arrangement. A higher minimum payment may be meaningless if there is no sharing over that amount and a competing bid provides for sharing with the expectation that it will produce a substantially higher level of revenues than the minimum payment.

To that end, the Company provided the amount of revenues generated under the existing (full outsourcing) arrangement with MLCI (RR-DTE-1 (conf.)). The record shows that, under the existing agreement, customers received a total value in one year that exceeded even the highest minimum payment offered under a full outsourcing arrangement in this RFP process. The record shows that it is the Company's expectation that MLCI's ability to generate such a high level of revenues may be tempered under the co-management arrangement because it will not have as much autonomy and control over the critical operations of the KeySpan assets. However, the record evidence also supports the Company's decision to partner with MLCI has the highest probability of providing customers with total benefits well in excess of the proposed minimum payment and comparable to other bids involving a *full* outsourcing arrangement (Exh. KED-AG-1-2 (supp.); RR-DTE-1).

Lastly, the Attorney General contends that "a review of past earnings shows that the MLCI proposal may not produce the level of savings for customers that they would have enjoyed under the proposals that the Company rejected"[3] (*citing* Exh. KED-DTE-1-6; Exh. KED-AG-1-2 (supp.); Tr. at 21-31). The only other proposal rejected by the Company that contemplated the co-management arrangement (and therefore is comparable to the Agreement) offered virtually the same value to customers as the MLCI proposal. In fact, the terms of that bid were not even as favorable as the proposed Agreement with MLCI, because the first increment of revenues obtained by the asset manager over the minimum payment to customers would *not* have been subject to sharing with customers, as it is under the proposed Agreement (see Exh. KED-AG-1-7, at 5-9 (conf.)). Moreover, the historical results achieved under the existing agreement with MLCI indicate that, under a co-management arrangement, there is a high probability that customers will receive benefits at least equal to the value offered by the two lowest bidders who were excluded from the short list. Therefore, the record establishes that (1) MLCI has provided a high level of value in managing the KeySpan assets in the past; (2) MLCI was the highest bidder in this process at any point of evaluation; and (3) the Agreement with MLCI will provide the highest level of value to customers structured as a co-management arrangement.

Accordingly, the record shows that the Company has selected as its partner the bidder offering an arrangement that represents the highest possible value for customers based on portfolio and market conditions at the time KeySpan entered into the contract. Accordingly, the Department should reject the Attorney General's request to deny approval of the Agreement and approve the proposed Agreement as filed.

3. The Attorney General requests that the Department reject the Company's proposal to "circumvent" the Department's margin sharing rules set out in D.P.U. 93-141-A.

According to the Attorney General, the terms of the Agreement create "an incentive for the Company to enter into transactions and to procure resources that would maximize margins at the expense of Massachusetts customers" (Attorney General at 4). The Attorney General claims that the Company has an incentive to use customer dollars to procure assets in excess of customer requirements or to procure high cost assets for use in transactions that would generate excess margins for shareholders (id.). The Attorney General further claims that customers would then pay the cost of excess or high-cost assets through the CGA and the harm from such an added cost may not be off-set by a customer share of the excess margin (id.). Significantly, the Attorney General offers no other basis for applying the D.T.E. 93-141-A framework. The Attorney General's claim is objectionable to the Company for several reasons, not the least of which is that it suggests that KeySpan would procure a specific capacity resource for no other reason than to generate greater optimization revenues to the benefit of shareholders.

In that regard, the Attorney General's claim either overlooks the fact that Department approval of capacity procurements is required or suggests that the Department's approval could be obtained even where the resource is not needed or is a more expensive option that other reasonable available alternatives. However, the approval process requires the gas company procuring capacity to demonstrate a need for the capacity using an approved Long Range Resource and Requirements plan and to show that the resource compares favorably to a range of reasonably available alternatives. The Department's analysis is thorough and complete. Therefore, for the Attorney General's scenario to be plausible, the gas company would also have had to create a false need for capacity in the most recently approved supply plan or a false analysis of available alternatives.

Third, the Attorney General's claim is misguided because the D.P.U. 93-141-A framework allows a gas company to retain a share of the margins only to the extent that the total revenues *exceed a threshold* established by the capacity-release revenues in the past annual period. The Attorney General's claims would be equally applicable to treatment under D.P.U. 93-141-A because, arguably, one way to exceed the threshold would be to add more capacity and then use it to obtain capacity-release revenues that would not have been available in the prior period. Therefore, the proposed Agreement provides no more incentive in this regard than the existing D.P.U. 93-141-A framework.

Notably, the Attorney General offers no other basis for rejecting the Company's proposal to treat the Agreement outside the parameters of the D.P.U. 93-141-A framework. In fact, the record shows that customers will be *better off* under the proposed Agreement than they are under the existing arrangement at each respective revenue level (because they are not sharing with KeySpan). Accordingly, the Department should approve the proposed Agreement as filed.

4. **The Attorney General requests that the Department expand its standard of review for non-cost factors given the complexity of the trades associated with asset optimization agreements. The Attorney General contends that the Department should make sure that any optimization agreement results in (1) transparent transactions, (2) a verifiable paper trail contemporaneously created with transactions, and (3) trades that benefit only Massachusetts customers.**

With respect to the Department's consideration of "non-price" factors in reviewing a proposed gas contract, the Department has stated that "in comparing the proposed resource acquisition to current market offerings, the Department examines relevant price and non-price attributes of each contract to ensure a contribution to the strength of the overall supply portfolio. Boston Gas Company, D.T.E. 04-9, at 10; Commonwealth Gas Company, D.P.U. 94-174-A, at 28 (emphasis added).

In this case, the record shows that the Company retained the services of PriceWaterhouseCoopers to conduct both a risk-management assessment and an accounting review related to the Company's existing contractual arrangement with MLCI (approved by the Department in D.T.E. 06-9) (Exh. KED-AG-1-8; Tr. at 50-51). The record also shows that the audit verified the revenues previously reported and allocated to customers in the peak-period CGA filings submitted to the Department (Exh. KED-AG-1-8). In addition, the record shows that the Company implemented certain subsidiary findings of the audit by instituting reporting protocols in the proposed Agreement to ensure the transparency of the revenue accounting under the arrangement (Tr. at 51-52). In that regard, the record shows that the proposed Agreement includes daily and monthly reporting requirements that were not part of the existing agreement with MLCI and that will ensure transparency in determining how revenues were earned (Exh. KED-AG-1-9; Tr. at 52). Lastly, the Company has retained the right under the Agreement to initiate an audit of the transactions undertaken by MLCI at any time (id.). Therefore, the protections built into the Agreement by virtue of the reporting and auditing requirements "ensure a contribution to the strength of the overall supply portfolio," consistent with the Department's standard for approval of gas supply contracts under Section 94A.

The Attorney General claims that "the lack of external checks and audits on transactions under the Proposed Agreement leaves the Department without a means to monitor whether KSCS and Merrill Lynch entered into transactions for the sole benefit of customers" (Attorney General at 4). This proposition is not supported by any record evidence. In fact, to support his contention, the Attorney General cites to the very provision in the contract that provides for record retention and auditing of the transactions undertaken as part of the Agreement, as well as to testimony of KeySpan's witness explaining that reporting and auditing requirements, which are not part of the existing agreement, were built into the proposed Agreement to ensure transparency (Attorney General at 4, citing Exh. EDA-3, at Section XII; Tr. 48-53).[2] The Attorney General provides no explanation or argument as to the reasons that these provisions are insufficient to protect the interests of customers, nor is there any evidence to this effect.

Therefore, the Attorney General's recommendation that the standard of review should be modified or is somehow not met in this proceeding must be rejected by the Department.

5. The Attorney General requests the Department to investigate whether the Company's inability to manage basic day-to-day procurement or to optimize its assets over the long-run will harm its customers.

The Attorney General claims that the record in this case makes it "clear that the Company lacks the ability to provide least cost reliable gas service to its Massachusetts customers on a long-term basis" (Attorney General at 4, citing Exh. EDA-1, at 15-17). Therefore, the Attorney General requests that the Department investigate whether the Company's "inability to manage basic day-to-day procurement or to optimize its assets over the long-run will harm its customers" (id. at 5).

The Company has two responses to this baseless claim. First, the Attorney General's claim that the Company's representations in this proceeding regarding the high-level of expertise and experience that is needed, in the absence of a portfolio manager, to perform a select set of activities is equal to an "inability to provide least cost reliable gas service" to its Massachusetts customers is gratuitous and baseless. In fact, there is a wealth of record evidence establishing both the Company's in-house capabilities and the nature and scope of the in-house capability that the Company is looking to enhance (see, e.g., Exh. EDA-1, at 15-17, 19; Exh. KED-AG-1-12; Exh. Exh. KED-DTE-1-5; Exh. KED-DTE-1-10; Tr. 68-70). This evidence establishes that the Company's need involves a narrow set of activities, which are backstopped by resources employed in relation to the New York resource portfolio. As a result, the Attorney General's claim is baseless and belies any true concern with the Company's provision of service to gas customers.

Second, the Company's proposal is expressly designed to address any concern that may exist with respect to long-term reliability of the resource portfolio because of the Company's previous reliance on the use of a portfolio manager.

Accordingly, the Department should reject the Attorney General's request for an investigation and approve the Agreement as filed.

6. Conclusion

The Asset Optimization Agreement represents the highest possible value for customers in light of current market conditions and the need to meet critical portfolio objectives (reliability, flexibility and diversity of supply). Accordingly, the Department should find that the proposed Agreement is consistent with the Company's portfolio objectives and compares favorably to

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[2] As explained by Ms. Arangio at the hearing, Exh. EDA-3, Article X, at page 16 establishes requirements for "Reporting and Reconciliation of Accounts" and Article XII, at page 20 establishes requirements for Records (retention and auditing) (Tr. at 49).

current market offerings considering price and non-price factors, and therefore, is consistent with the public interest.

The Company greatly appreciates the Department's consideration of this matter.

Very truly yours,

Cheryl M. Kimball

Enclosures

cc: Service List